

**Management Advisory Report:
Tax Return Filing and Examination Statistics**

September 2001

Reference Number: 2001-30-175

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 21, 2001

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in black ink, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Management Advisory Report - Tax Return Filing
and Examination Statistics

This management advisory report presents the results of our review of statistical information that impacts the Examination function. The overall objective of this review was to provide statistical information requested by the Internal Revenue Service (IRS) Oversight Board.

In summary, as has been reported by the Treasury Inspector General for Tax Administration¹ and the media in recent years, the number of tax returns selected for examination by the IRS has decreased, while the number of tax returns filed by taxpayers has increased. As a result, the number of tax returns examined went from 1 out of every 79 in 1988 to 1 out of every 232 in 2000. This drop has been particularly drastic since the beginning of 1998.

Decreases in the examination rate can be partially attributed to:

- A 25 percent decline in the number of revenue agents² and tax auditors³ since Fiscal Year (FY) 1995.

¹ *Management Advisory Report: Evaluation of Reduction in the Internal Revenue Service's Compliance Activities* (Reference Number 2000-30-075, dated May 2000).

² A revenue agent is an Examination function employee that examines more complex tax returns.

³ A tax auditor is an Examination function employee that examines less complex tax returns.

- A decline in the percent of direct examination time,⁴ from 49 percent in FY 1998 to 41 percent in FY 2000.
- An increase in time per return by revenue agents. For example, hours per return for individual and corporation returns increased by 24 percent and 47 percent, respectively, from FYs 1998 to 2000.

In addition to the increase in the number of returns filed, income amounts from various sources increased between Tax Years 1990 and 1998.

We made no recommendations in this report. However, information in this report could be useful to IRS officials who are responsible for establishing the annual examination plan that details the number and types of tax returns to be examined each year. In addition, these results might be useful to the Examination Reengineering team.⁵

Please contact me at (202) 622-6510 if you have questions or your staff may call Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

⁴ Direct examination time is the time actually spent by Examination function employees to conduct tax examinations.

⁵ The Small Business/Self-Employed Division Examination function formed a reengineering team to perform an in-depth review of examination processes, products, and services.

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Tax Return Filing and Examination Statistics**

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Management Advisory Report: Tax Return Filing and Examination Statistics

Background

We initiated this review of nationwide statistical information that impacts the Examination function at the request of the Internal Revenue Service (IRS) Oversight Board. We relied on information accumulated by the IRS and did not verify the accuracy of the information. We performed this review between June and August 2001 in Chicago, Illinois, in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections*. Major contributors to this report are listed in Appendix I.

Summary of Statistical Information

As has been reported by the Treasury Inspector General for Tax Administration (TIGTA)¹ and the media in recent years, the number of tax returns examined by the IRS has decreased while the number of tax returns² filed by taxpayers has increased. As a result, the number of tax returns examined went from 1 out of every 79 in 1988 to 1 out of every 232 in 2000. This drop has been particularly drastic since the beginning of 1998. For example, the following is a comparison of information from 1998 to 2000:

- Non-business individual tax returns³ filed **increased** by 6 percent, while the number of returns examined **decreased** by 61 percent.
- Business individual tax returns⁴ (excluding farms) filed **increased** by 6 percent, while the number of returns examined **decreased** by 48 percent.
- S Corporation tax returns⁵ filed **increased** by 21 percent, while the number of returns examined **decreased** by 36 percent.

¹ *Management Advisory Report: Evaluation of Reduction in the Internal Revenue Service's Compliance Activities* (Reference Number 2000-30-075, dated May 2000).

² When referring to tax returns we include any type of return filed by taxpayers, whether taxable or not.

³ Non-Business individual tax returns include income primarily from wages, dividends, and interest.

⁴ Business individual tax returns include primarily business income as reported on a Profit or Loss from Business (Schedule C).

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Decreases in the examination rate can be partially attributed to:

- A 25 percent decline in the number of revenue agents⁶ and tax auditors⁷ since Fiscal Year (FY) 1995.
- A decline in the percent of direct examination time,⁸ from 49 percent in FY 1998 to 41 percent in FY 2000. Part of this change can be attributed to additional training as a result of the IRS Restructuring and Reform Act of 1998,⁹ and time spent by Examination employees assisting with Customer Service activities.
- An increase in time per return by revenue agents. For example, hours per return for individual and corporation returns increased by 24 percent and 47 percent, respectively, between FYs 1998 and 2000. During the same time period, the proposed tax adjustment amount per hour of examination time decreased by 7 percent for individual returns and 22 percent for corporation returns.¹⁰

In addition to the increase in the number of returns filed, income amounts from various sources increased between Tax Years (TY) 1990 and 1998 (years for which the data were available). For example, the number of individual tax returns filed with:

- Business or profession net income increased 17 percent, and the amount of income increased 40 percent (from \$161.66 to \$226.14 billion).
- A net capital gain (e.g., sale of stocks) increased by 127 percent, and the amount of income increased 268 percent (from \$123.78 to \$455.22 billion).

⁵ An S Corporation is a small business corporation that passes income and losses through to shareholders for tax purposes.

⁶ A revenue agent is an Examination function employee that examines more complex tax returns.

⁷ A tax auditor is an Examination function employee that examines less complex tax returns.

⁸ Direct examination time is the time actually spent by Examination function employees to conduct tax examinations.

⁹ Pub. L. No. 105-206, 112 Stat. 685.

¹⁰ Compared to FY 1999, dollars per return increased in FY 2000.

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- Partnership and S Corporation income increased 26 percent, and the amount of income increased 115 percent (from \$112.03 to \$240.84 billion).

Additional details follow for the Examination function staffing levels and time spent on cases, tax returns filed and examined by type of tax return, and dollar amounts of certain types of income reported on individual tax returns.

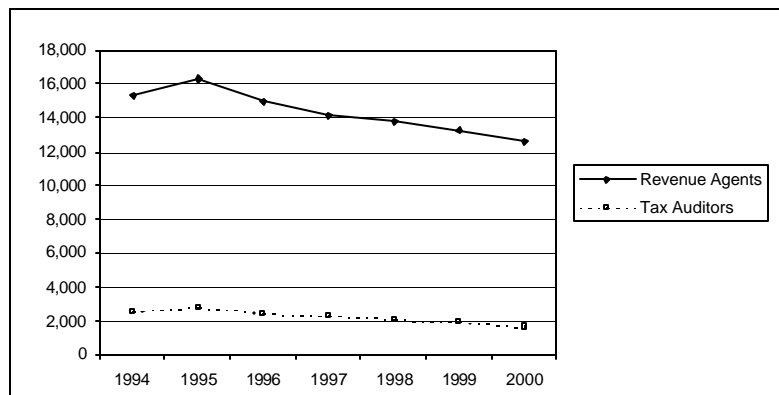
Examination Function Staffing and Time

The following charts show the Examination function staffing and the percent of direct and non-direct examination time. The information is based on data obtained from Examination Table 37, Examination Program Monitoring, for FYs 1994 through 2000.

Examination Staffing

Since FY 1995, the number of revenue agents and tax auditors **decreased** by 25 percent. Figure 1 shows the number of revenue agents and tax auditors as of the end of FYs 1994 through 2000.

Figure 1. Examination Staffing



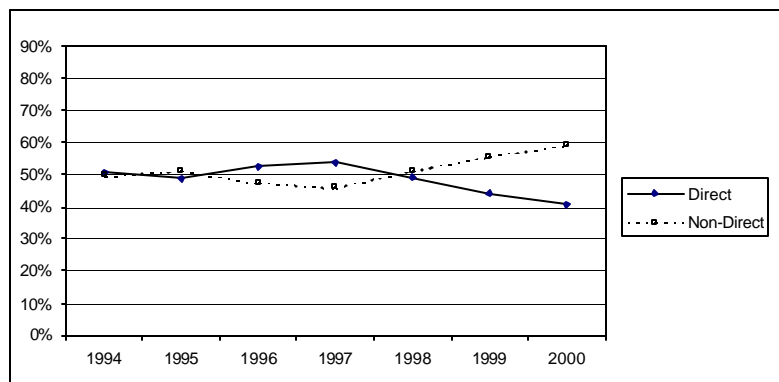
Source: Examination Table 37

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Examination Time

Since FY 1998, the percent of non-direct examination time **increased** by eight percent, while direct examination time **decreased** by the same amount. Non-direct examination time consists of direct support time and non-examination time. Direct support time is for activities such as identifying tax returns to examine, group management activities, and quality reviews. Non-examination time consists of items such as administrative duties, time spent assisting other IRS functions, training, and leave.¹¹ The latter two account for about 50 percent of the non-examination time. Figure 2 shows direct and non-direct examination time as a percentage of total examination time.

Figure 2. Percent of Direct and Non-Direct Examination Time



Source: TIGTA Analysis of Examination Table 37 Data

In addition, revenue agents are spending more time per return. For example, hours per return for individual returns and corporation returns **increased** by 24 percent and 47 percent, respectively, from FYs 1998 to 2000. During the same time period, the proposed tax adjustment amount per hour of examination time **decreased** by 7 percent for individual returns and 22 percent for corporation returns.

Number of Tax Returns Filed and Examined

Information in this and the following sections shows the percent change from 1988 in the number of tax returns filed and examined for various types of tax returns. The

¹¹ Leave includes vacation and sick days.

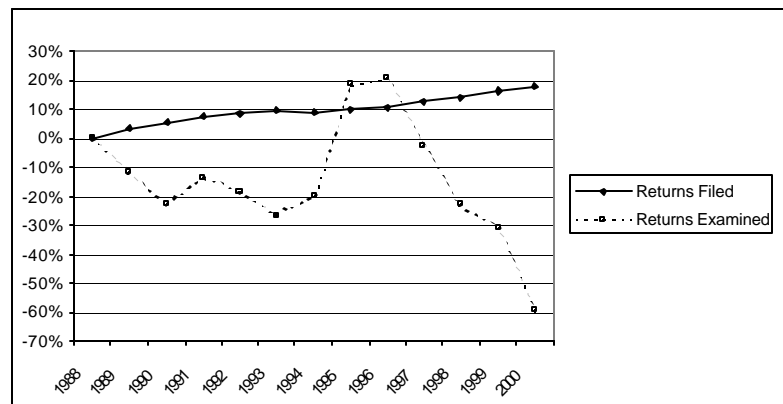
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information is based on data from the IRS Data Books¹² for 1988 through 2000. We used the IRS' method for computing examination rates. For all categories of tax returns, the examination rate equals the proportion of IRS examinations closed in a fiscal year compared to returns filed in the previous calendar year.

The number of tax returns examined does not include notices sent to taxpayers as a result of the IRS' document matching program. This program compares third-party information, such as wages paid by employers and interest paid by banks, to the amount of income reported on the appropriate income tax return.

From 1988 to 2000, the total number of tax returns filed **increased** by 18 percent (from 140.33 to 165.77 million). During the same time period, the number of tax returns examined **decreased** by 60 percent (from 1.77 million to 715,915). Taking both statistics into account, the number of tax returns examined went from 1 out of every 79 in 1988 to 1 out of every 232 in 2000.

Figure 3. Examination Coverage of All Returns Filed – Percent Change From 1988



Source: TIGTA Analysis of IRS Data Book Information

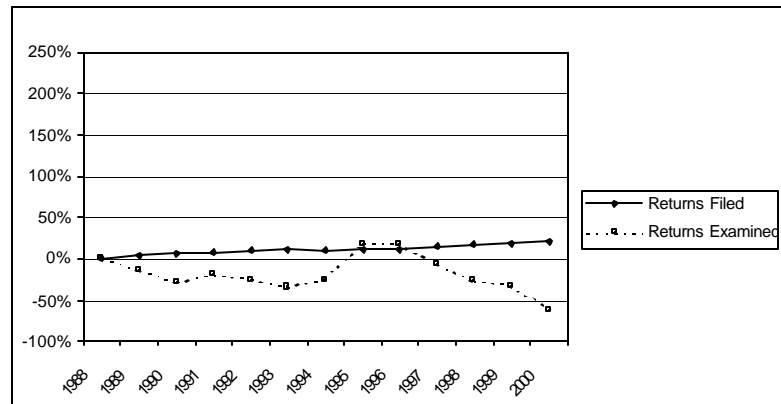
¹² The IRS Data Books provide annual statistical and organizational information about the IRS.

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Individual Tax Returns Filed and Examined

From 1988 to 2000, the number of individual tax returns filed **increased** by 21 percent (from 103.25 to 124.89 million). The number of individual tax returns examined; however, **decreased** by 62 percent (from 1.62 million to 617,765).

Figure 4. Examination Coverage of All Individual Tax Returns - Percent Change From 1988



Source: TIGTA Analysis of IRS Data Book Information

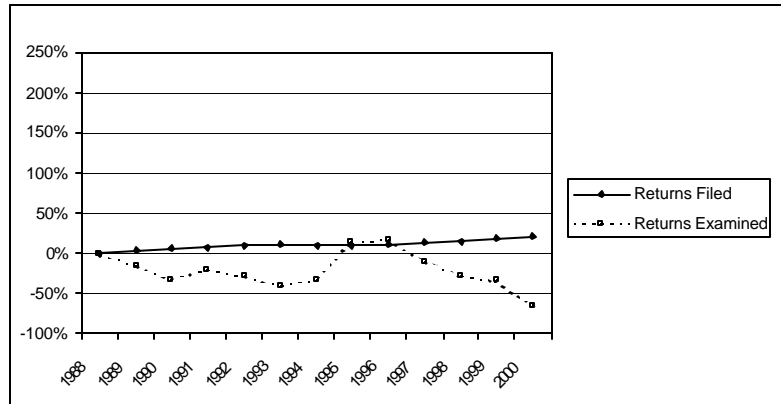
The following charts provide statistics from 1988 to 2000 for the various types of individual tax returns.

Non-Business Individual Tax Returns

These are individual tax returns that contain income primarily from wages, dividends, and interest (non-business income). The number of these tax returns filed **increased** by 20 percent (from 97.02 to 116.39 million). The number of these tax returns examined **decreased** by 65 percent (from 1.42 million to 492,529).

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Figure 5. Individual Tax Returns With Primarily Non-Business Income - Percent Change From 1988

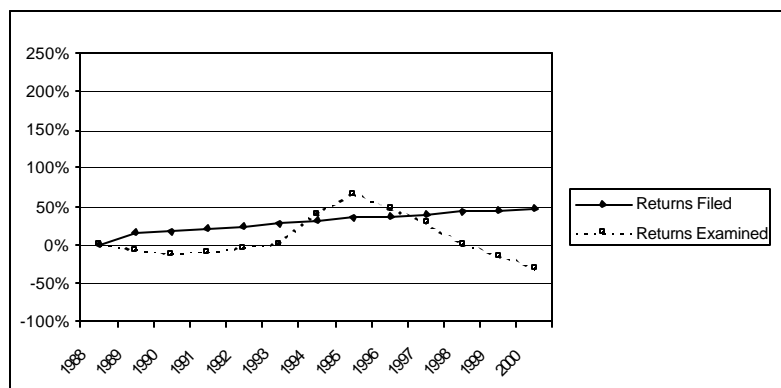


Source: TIGTA Analysis of IRS Data Book Information

Business Individual Tax Returns (Excluding Farms)

These are individual tax returns that contain primarily business income as reported on a Profit or Loss from Business (Schedule C). The number of these tax returns filed **increased** by 48 percent (from 5.30 to 7.84 million), while the number examined **decreased** by 32 percent (from 178,076 to 121,702).

Figure 6. Examination Coverage of Individual Tax Returns With Primarily Business Income (Excluding Farms) – Percent Change From 1988



Source: TIGTA Analysis of IRS Data Book Information

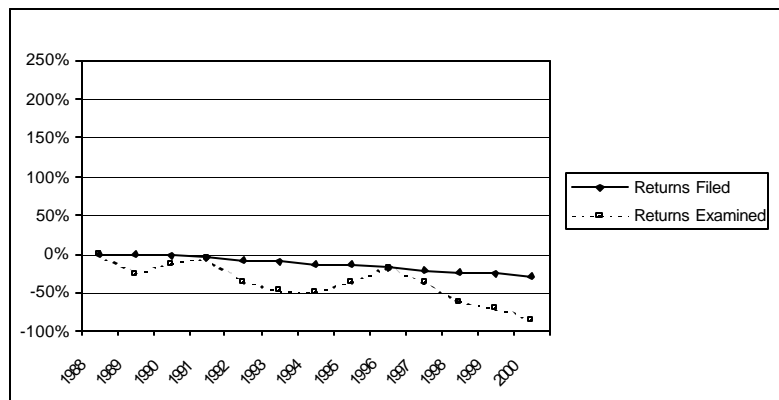
Farm Business Individual Tax Returns

These are individual tax returns that contain primarily farm business income as reported on a Profit or Loss from Farming (Schedule F). The number of these tax returns

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filed **decreased** by 29 percent (from 929,000 to 659,300), and the number examined **decreased** by 84 percent (from 21,480 to 3,534).

Figure 7. Examination Coverage of Individual Tax Returns With Primarily Farm Business Income – Percent Change From 1988

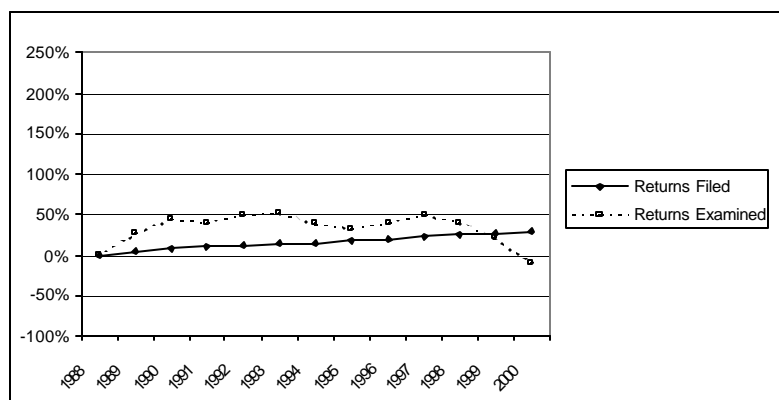


Source: TIGTA Analysis of IRS Data Book Information

Corporation Tax Returns Filed and Examined

During the same 13-year period, the number of corporation tax returns filed **increased** by 29 percent (from 3.76 to 5.28 million). The number of corporation tax returns examined **decreased** by 10 percent (from 47,581 to 43,383). The number of examinations actually kept pace with the increase in returns filed until 1998, then decreased.

Figure 8. Examination Coverage of All Corporation Tax Returns - Percent Change From 1988



Source: TIGTA Analysis of IRS Data Book Information

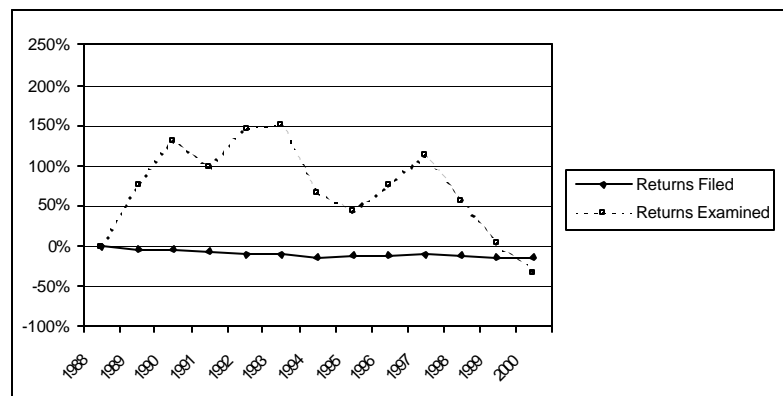
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The following charts provide statistics from 1988 to 2000 based on corporation asset value and various types of corporation tax returns.

Corporation Tax Returns With No Balance Sheet¹³ or With Assets of Under \$5 Million

The number of these tax returns filed **decreased** by 14 percent (from 2.78 to 2.40 million), and the number examined also **decreased** by 32 percent (from 24,425 to 16,582). While the number of examinations fluctuated during this time period, the number significantly decreased beginning in 1998.

Figure 9. Examination Coverage of Corporations With No Balance Sheet or With Assets of Under \$5 Million – Percent Change From 1988



Source: TIGTA Analysis of IRS Data Book Information

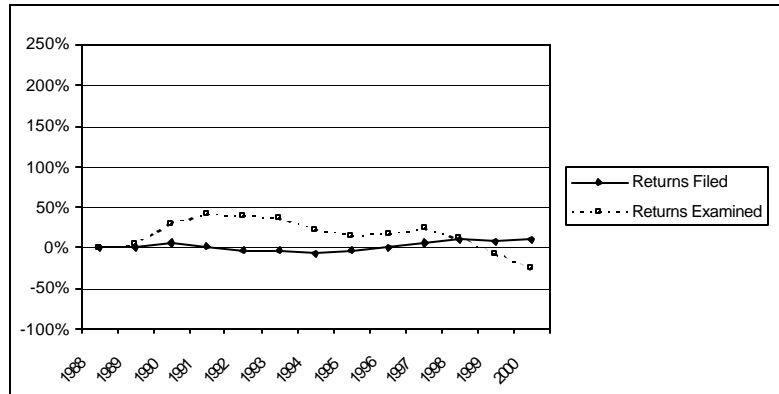
Corporation Tax Returns With Assets of at Least \$5 Million, but Under \$250 Million

The number of tax returns filed by these taxpayers **increased** by 10 percent (from 69,000 to 75,900). At the same time, the number of these tax returns examined was **decreasing** by 26 percent (from 11,079 to 8,173).

¹³ A balance sheet presents the financial position of a business.

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Figure 10. Examination Coverage of Corporations With Assets of \$5 Million but Under \$250 Million – Percent Change From 1988

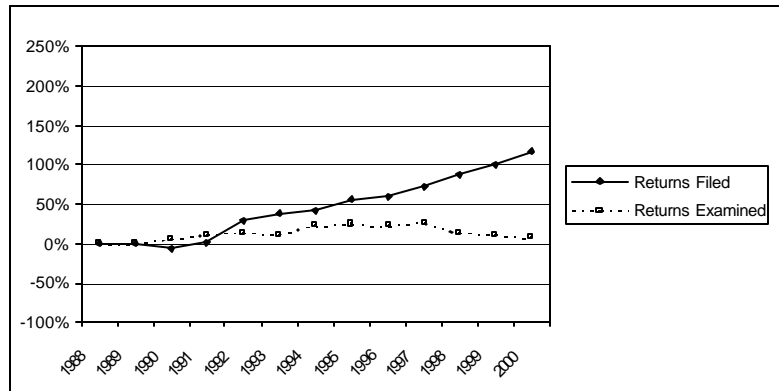


Source: TIGTA Analysis of IRS Data Book Information

Corporation Tax Returns With Assets of \$250 Million and Over

From 1988 to 2000, the number of these tax returns filed **increased** by 118 percent (from 4,500 to 9,800), and the number examined also **increased** by 7 percent (from 2,880 to 3,080).

Figure 11. Examination Coverage of Corporations With Assets of \$250 Million And Over – Percent Change From 1988



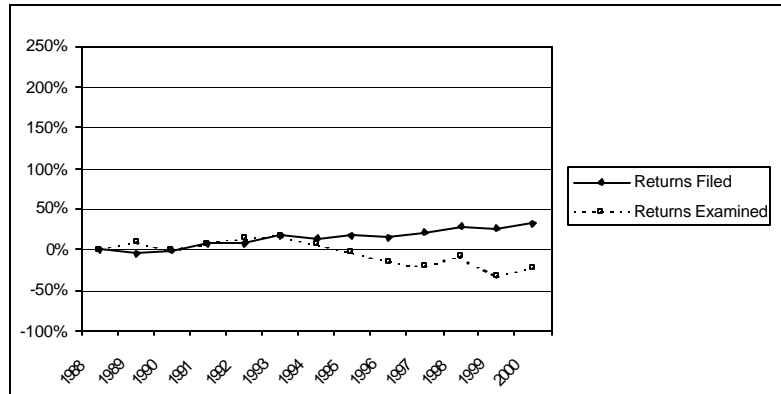
Source: TIGTA Analysis of IRS Data Book Information

Foreign Corporation Tax Returns

The number of such tax returns filed **increased** by 33 percent (from 17,000 to 22,600). However, the number examined **decreased** by 21 percent (from 440 to 348).

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Figure 12. Examination Coverage of Foreign Corporation Tax Returns – Percent Change From 1988

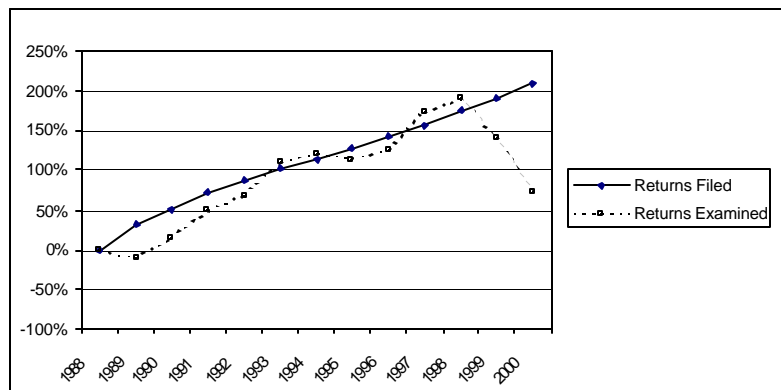


Source: TIGTA Analysis of IRS Data Book Information

S Corporation Tax Returns

The number filed **increased** by 210 percent (from 892,000 to 2.77 million), and the number examined **increased** by 74 percent (from 8,757 to 15,200). While the number of examinations kept pace with the number of returns filed through 1998, the number decreased significantly in 1999 and 2000.

Figure 13. Examination Coverage of S Corporation Tax Returns - Percent Change From 1988



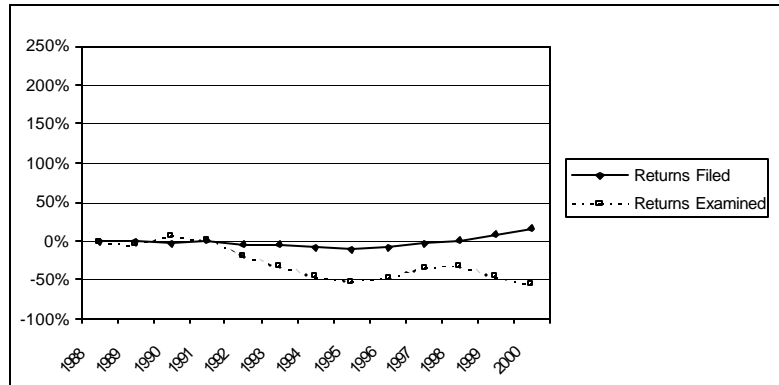
Source: TIGTA Analysis of IRS Data Book Information

Partnership Tax Returns Filed and Examined

The number of partnership tax returns filed **increased** by 16 percent (from 1.70 to 1.97 million) from 1988 to 2000. On the other hand, the number of these tax returns examined **decreased** by 55 percent (from 14,652 to 6,539).

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**Figure 14. Examination Coverage of Partnership
Tax Returns - Percent Change From 1988**

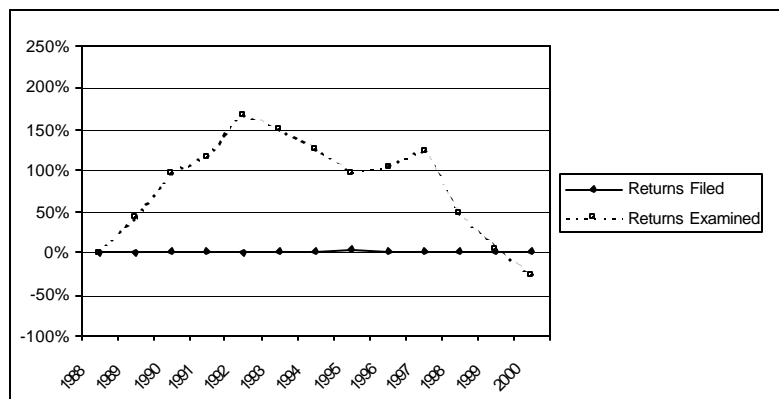


Source: TIGTA Analysis of IRS Data Book Information

Employment Tax Returns Filed and Examined

Between 1988 and 2000, the number of employment tax returns filed **increased** by 3 percent (from 28.17 to 29.00 million). However, the number of these tax returns examined **decreased** by 26 percent (from 27,270 to 20,074). The number of returns examined did not drop below the 1988 level until 2000. However, a downward trend occurred since 1997. Since then, the number of examinations dropped by 67 percent.

**Figure 15. Examination Coverage of Employment Forms – Percent
Change From 1988**



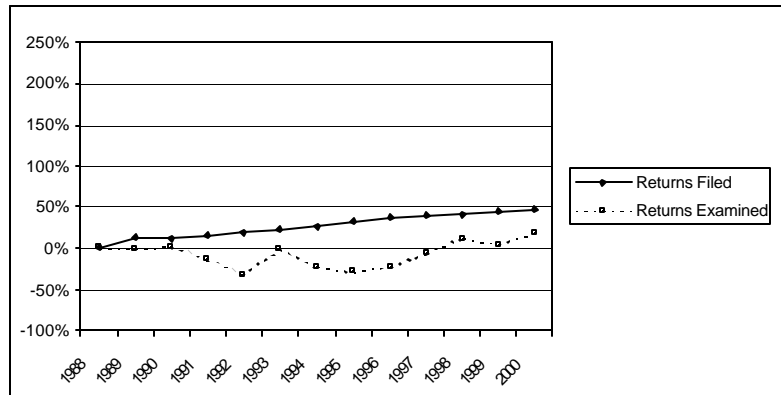
Source: TIGTA Analysis of IRS Data Book Information

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Fiduciary Tax Returns Filed and Examined

From 1988 to 2000, the number of fiduciary tax returns filed **increased** by 46 percent (from 2.34 to 3.40 million). The number of these tax returns examined also **increased** by 19 percent (from 6,138 to 7,318).

Figure 16. Examination Coverage of Fiduciary Tax Returns Filed- Percent Change From 1988

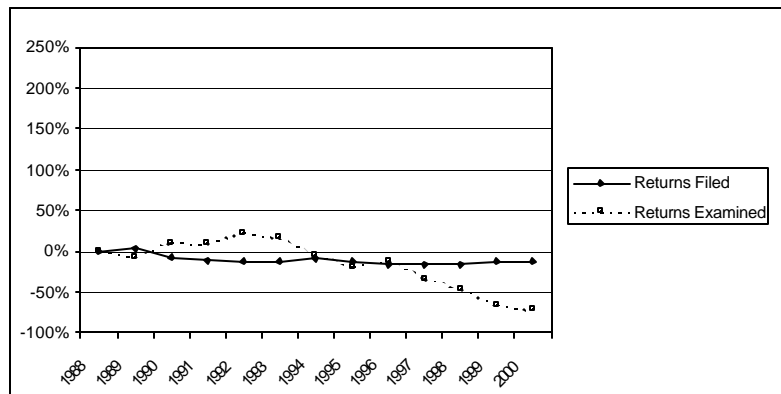


Source: TIGTA Analysis of IRS Data Book Information

Excise Tax Returns Filed and Examined

The number of excise tax returns filed **decreased** by 14 percent (from 952,204 to 822,200). The number of these tax returns examined also **decreased** by 72 percent (from 37,231 to 10,294).

Figure 17. Examination Coverage of Excise Tax Returns – Percent Change From 1988



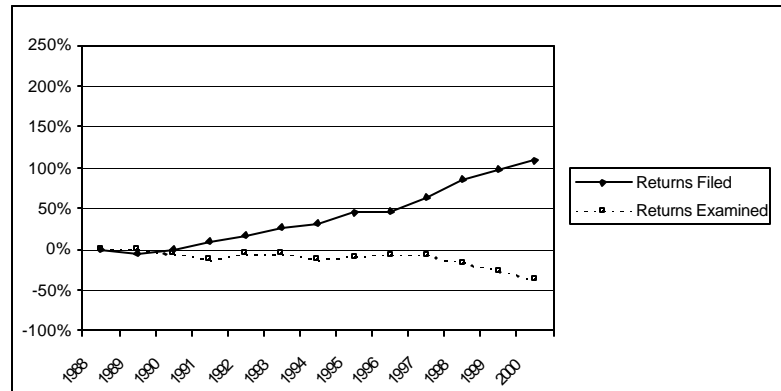
Source: TIGTA Analysis of IRS Data Book Information

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Estate Tax Returns Filed and Examined

The number of estate tax returns filed **increased** by 110 percent (from 55,500 to 116,500), while the number of these tax returns examined **decreased** by 37 percent (from 12,640 to 8,024).

Figure 18. Examination Coverage of Estate Tax Returns – Percent Change From 1988

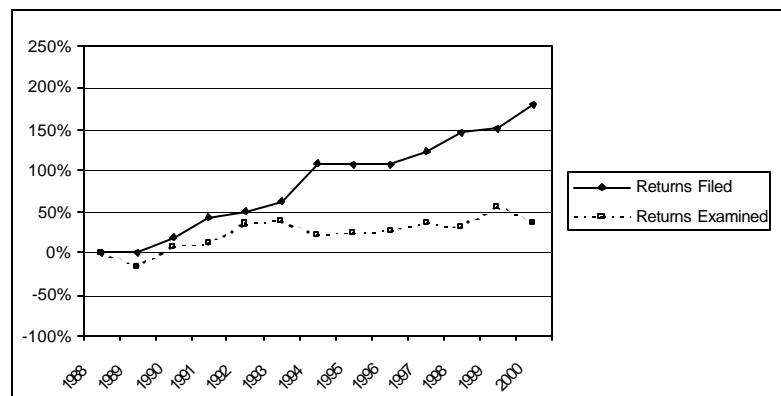


Source: TIGTA Analysis of IRS Data Book Information

Gift Tax Returns Filed and Examined

The number of gift tax returns filed **increased** by 181 percent (from 104,000 to 291,900) between 1988 and 2000. The number of these tax returns examined also **increased** by 38 percent (from 1,518 to 2,097).

Figure 19. Examination Coverage of Gift Tax Returns – Percent Change From 1988



Source: TIGTA Analysis of IRS Data Book Information

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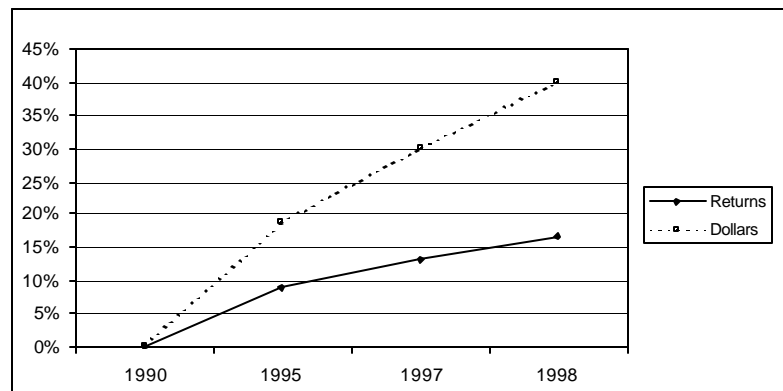
Number of Individual Tax Returns Filed and Dollar Amounts for Selected Line Items

Information in the following charts shows the percent change in the number of individual tax returns filed and dollar amounts on selected line items.¹⁴ The information is based on data obtained from the IRS' Statistics of Income Table 1, Individual Income Tax Returns: Selected Income and Tax Items for Specified Tax Years.¹⁵ The data were available for TYs 1990, 1995, 1997, and 1998, and are presented as a percent of change from TY 1990.

Business or Profession Net Income

The number of individual income tax returns filed including business or profession net income **increased** by 17 percent (from 11.22 to 13.08 million). The income **increased** by 40 percent (from \$161.66 to \$226.14 billion).

Figure 20. Individual Returns With Business or Profession Net Income – Percent Change From Tax Year 1990



Source: TIGTA Analysis of IRS Statistics of Income Data

Business or Profession Net Loss

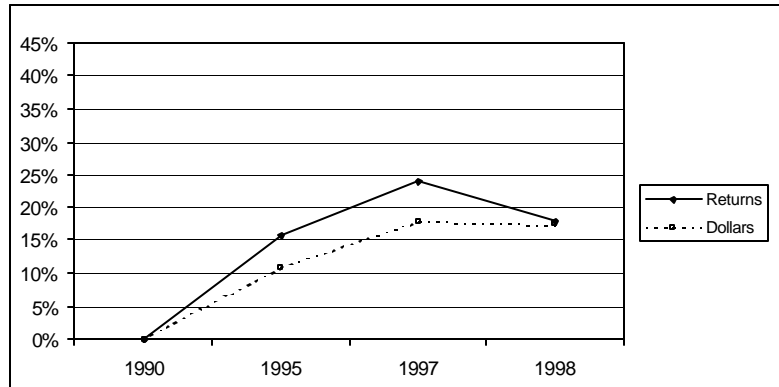
The number of individual income tax returns filed including business or profession net loss **increased** by 18 percent (from 3.42 to 4.02 million). The loss **increased** by 17 percent (from \$20.23 to \$23.74 billion).

¹⁴ Line items are income amounts from various lines included on individual tax returns.

¹⁵ These Statistics of Income figures are estimates based on samples of data.

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Figure 21. Individual Returns With Business or Profession Net Loss - Percent Change From Tax Year 1990

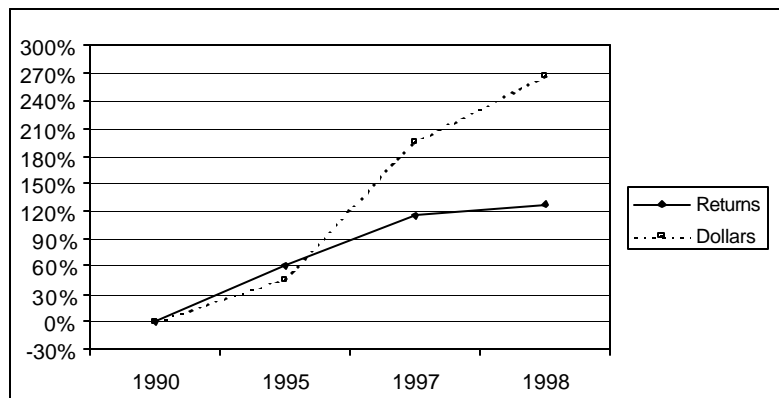


Source: TIGTA Analysis of IRS Statistics of Income Data

Net Capital Gain in Adjusted Gross Income¹⁶

The number of individual income tax returns filed including a net capital gain (e.g., from the sale of stocks) in Adjusted Gross Income (AGI) **increased** by 127 percent (from 9.22 to 20.96 million), and the amount of the gain **increased** by 268 percent (from \$123.78 to \$455.22 billion).

Figure 22. Individual Returns With Net Capital Gain in AGI - Percent Change From Tax Year 1990



Source: TIGTA Analysis of IRS Statistics of Income Data

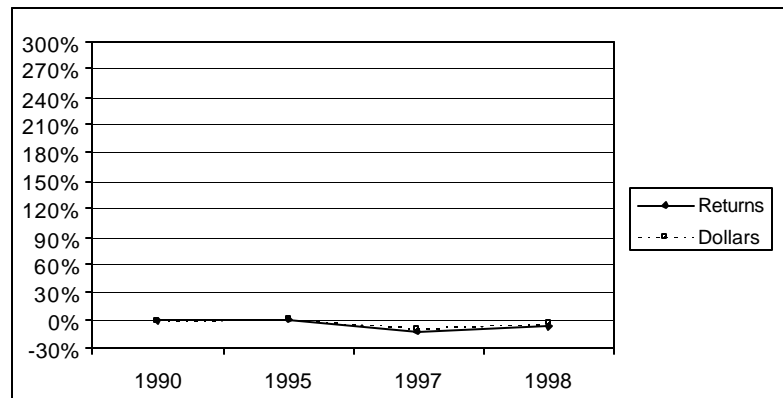
¹⁶ AGI is gross income minus certain deductions that are not included in taxable income and is the starting point in determining taxable income.

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Net Capital Loss in AGI

The number of individual income tax returns filed including a net capital loss in AGI **decreased** by 7 percent (from 5.07 to 4.73 million), and the amount of the loss **decreased** by 4 percent (from \$9.55 to \$9.14 billion).

Figure 23. Individual Returns With Net Capital Loss in AGI - Percent Change From Tax Year 1990

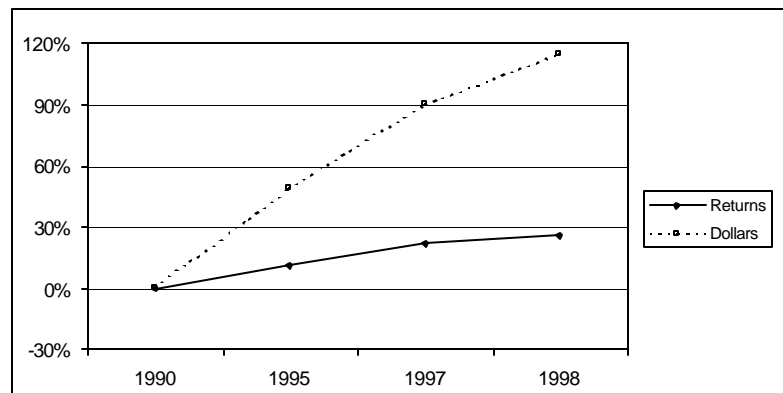


Source: TIGTA Analysis of IRS Statistics of Income Data

Partnership and S Corporation Net Income

The number of individual income tax returns filed including Partnership and S Corporation net income **increased** by 26 percent (from 3.21 to 4.03 million), and the net income **increased** by 115 percent (from \$112.03 to \$240.84 billion).

Figure 24. Individual Returns With Partnership And S Corporation Net Income – Percent Change From Tax Year 1990



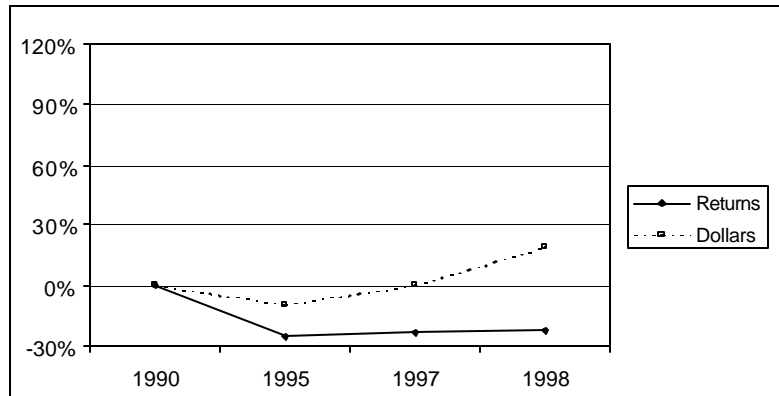
Source: TIGTA Analysis of IRS Statistics of Income Data

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Partnership and S Corporation Net Loss

The number of individual income tax returns filed including Partnership and S Corporation net loss **decreased** by 22 percent (from 2.77 to 2.15 million). The net loss amount **increased** by 19 percent (from \$45.01 to \$53.48 billion).

Figure 25. Individual Returns With Partnership and S Corporation Net Loss – Percent Change From Tax Year 1990

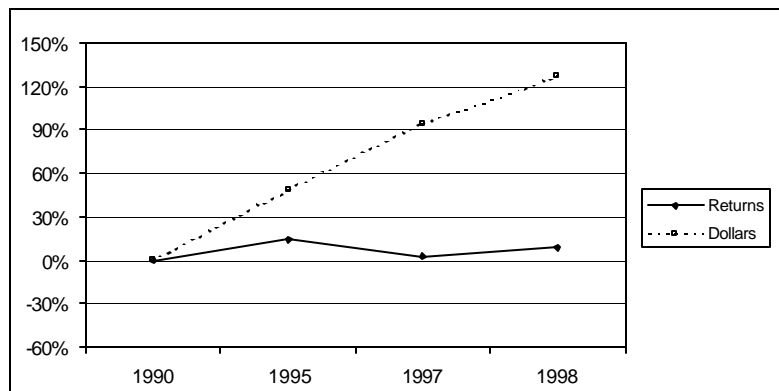


Source: TIGTA Analysis of IRS Statistics of Income Data

Estate or Trust Net Income

The number of individual income tax returns filed including estate or trust net income **increased** by 9 percent (from 444,953 to 484,763), and the income amount **increased** by 127 percent (from \$4.63 to \$10.50 billion).

Figure 26. Individual Returns With Estate or Trust Net Income - Percent Change From Tax Year 1990



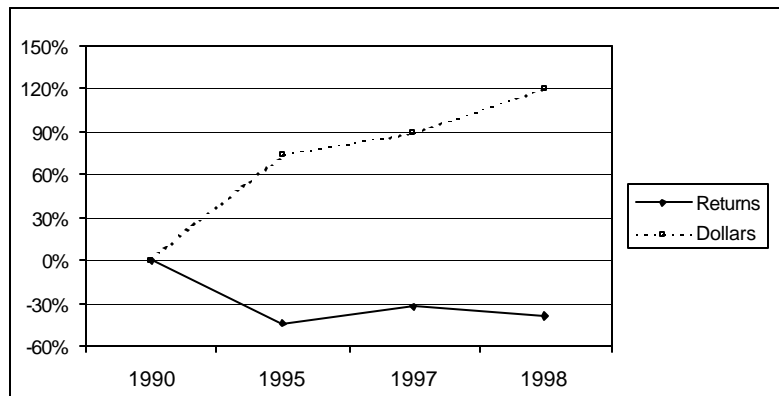
Source: TIGTA Analysis of IRS Statistics of Income Data

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Estate or Trust Net Loss

The number of individual income tax returns filed including estate or trust net loss **decreased** by 39 percent (from 74,127 to 45,412). The loss amount **increased** by 120 percent (from \$468 million to \$1.03 billion).

Figure 27. Individual Returns With Estate or Trust Net Loss - Percent Change From Tax Year 1990



Source: TIGTA Analysis of IRS Statistics of Income Data

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Appendix I

Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)

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Donald L. McDonald, Senior Auditor

Joseph P. Snyder, Senior Auditor

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Appendix II

Report Distribution List

Deputy Commissioner N:C
Commissioner, Large and Mid-Sized Business Division LM
Commissioner, Small Business/Self-Employed Division S
Commissioner, Wage and Investment Division W
Deputy Commissioner, Large and Mid-Sized Business Division LM
Deputy Commissioner, Small Business/Self-Employed Division S
Deputy Commissioner, Wage and Investment Division W
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M